April 15th: India

“In 1950 if someone had been asked to predict the Third World country most likely to embark on an industrial revolution and with the best prospects of fostering modern economic growth...the unanimous choice would have been India.” (Deepak Lal, 1988)
India is the second most populous country in the world. While per capita incomes are low, it has the world’s 12th largest GDP.

It is an example of a country that was deindustrialized as a result of the 19th century industrial revolution and associated agglomeration economies.

- (India had a significant textile industry prior to the emergence and dominance of Lancashire.

Evidence suggests that the gap in living standards between India and Europe was narrower in the 18th century than it became subsequently (an example of “divergence big time”).
Growth has now accelerated

- Growth has accelerated from a disappointing 1 ½ % p.a. 1950-80 to 5-6% in recent years.
- This is an impressive improvement.
- 2007 outturn was 9%, approaching Chinese levels.
Moreover, India has two important advantages relative to China

- Demography
- Democracy
Demography

- In much of Asia, the share of the working-age population will peak around 2010. In China it will peak around 2015. But in India it will keep rising until 2025.
- This implies rising savings rates (according to the life-cycle model).
- In turn this should support higher investment rates.
- And more of that investment can go into productive capacity (as opposed to health care for the elderly).
India is a stable multiparty democracy. China, on the other hand, is an autocratic one-party state.

To be sure, we know from our discussion of other transition economies that the connections between democracy and economic growth are complex.

Still there are reasons to think that a thriving multi-party democracy can better handle the adjustment problems posed by opening and adjustment to the market.

- In China, 40% of all bank loans are bad. This is why such high investment rates have not produced even faster growth. Would a democratic political system have allowed this?
- On the other hand, democracy means even more intense pressure for spending on public goods, making it hard to plow resources into investment in productive capacity.
- So there are factors cutting both ways.
- Someday China will have to undergo a political transition. What will that do to economic growth? Does India have an advantage in having already completed this transition?
iClicker question: which country will grow faster (in terms of real GDP) in the next ten years?

- A. India
- B. China
But, for the time being, India continues to lag China

- Per capita incomes in China (at PPP) are now twice as high, where they were the same 30 years ago. You would therefore expect India to be catching up, where it is not.
  - China’s growth rate remains even faster
- Poverty rates (as calculated by the World Bank) remain 25% in India, less than 5% in China.
- Investment rates in India are less than half as high.
- Savings rates are less than half as high. (Although household savings rates are pretty similar.)
- Employment share in the modern sector shows little sign of rising.
- Export growth is only half as fast as in China.

- Following four slides illustrate these points.
India’s growth has lagged China’s
A significant per capital income differential has opened up

Source: EIU

GDP per capita (PPP)

India

China

$6,270
(15% of U.S.)

$3,420
(8% of U.S.)

Source: EIU
India’s export performance has lagged

Exports of Goods and Services (US$ Billions)

Source: EIU
Household savings are lower (though the real difference is enterprise savings)

Household Savings: 2005 (% of disposable household income)

Source: OECD, China and India CEIC data 2004
India lags China virtually everywhere in sources of productivity growth per worker 1978-2004 (exceptions are education and TFP in services)

<table>
<thead>
<tr>
<th>Contribution of:</th>
<th>Growth rate of output per worker</th>
<th>Capital</th>
<th>Land</th>
<th>Education</th>
<th>Total Factor Productivity (TFP)</th>
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<td></td>
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Source: Bosworth and Collins (2007), Tables 1 and 2
So is India a success or a failure?
Why isn’t it growing faster?
Is the acceleration in the growth rate in 2006-7 a harbinger of better things to come? Or do chronic problems remain?

Some history may help us to put these questions in perspective.
Coming to power in the late 1940s, India’s charismatic post-independence leader, Jawaharlal Nehru, was impressed by the Soviet Union’s economic success.

(This was the era when development economists spoke of “big-push industrialization.”)
Nehru and other post-independence leaders were dirigiste

- The government sought to promote the growth of heavy industry in the Soviet mold (iron and steel, defense industries, etc. – the security situation following partition clearly being part of the motivation).

- A series of five year plans were developed to direct resources toward heavy industry. The financial system was repressed and heavy regulation was applied to implement the plan.

- The government built advanced institutions of higher learning (on the model of MIT) to provide the technically skilled workers needed to support these activities.

- At the same time, it sought to protect small firms, whose owners and workers were politically consequential, with “reservations” (special concessions for small producers) and restrictions on layoffs for employees (see above).

- To make all this work, it was forced to limit foreign competition.
The authorities, as noted, sought to advance these goals through a series of five year plans

- Notice the similarity with China...
  
  - First plan (1951-56) was little more than a compendium of investment projects.
  - Second plan (1956-61) emphasized investment in what were supposed to be complementary heavy industries. Since capital goods were imported, this led to a balance of payments crisis, in response to which imports were tightly controlled.
  - Next couple of plans again emphasized the development of heavy industry using cheap credit from the financial system and behind the shelter of import controls.
  - Investment planning and resource allocation generally were shaped by a comprehensive panoply of regulations and through government ownership and operation of the banking system.
Side effects of these policies and plans were not positive

- Critics referred to this intrusive system of reservations and central planning as “the license raj.”
- Licenses for investment and imports were vetted one by one by undertrained bureaucrats. Delays were endless. Costs were enormous. Opportunities for corruption were extensive.
- As late as 1990 permission was required for all investment outside of 18 narrowly defined industries (where investment was unrestricted, because these were viewed as priority industries).
Inward foreign direct investment (FDI) was restricted. Banks were used to advance the government’s industrial policy. They were required to keep half their deposits as reserves and turn these over to the authorities, which used them to stimulate the development of particular industries.

Restrictions were placed on firing workers for all firms with more than 100 employees.

Reservations for small firms limited entry of big firms into some sectors.

- This was designed to boost employment but confused labor-intensity with scale. Big firms can adopt labor intensive technologies too, and often at lower cost (by exploiting scale economies).

- One can imagine how all this didn’t make for a very flexible, efficient or innovative economy.
Understanding these policies requires understanding the history

- Restrictive labor laws reflected similar regulation imposed starting in 1880s, when British administrators sought to limit the competition felt by Lancashire by limiting hours. Very strong path dependence!

- Hostility to FDI (by multinationals in particular) reflected early experience with East Asia Company, which led to direct British colonial domination from the 1820s. Another example of very strong path dependence!

- Indian leaders were suspicious of openness: they looked back at the 19th century and saw that trade had deindustrialized the country. Nehru referred to trade as “a whirlpool of economic imperialism.”

- Indian independence came at a time when memories of the Great Depression were fresh and import substitution was widespread.

- As noted, Indian leaders were impressed by the Soviet Union’s success at transforming itself from an agricultural to an industrial economy in a generation and at its success by growing via resource mobilization. They also saw China, next door, attempting a great leap forward on the basis of planning.

- During WWII, the British had put in place an elaborate administrative mechanism to allocate scarce commodities (like cloth, grain and sugar), on which Indian planners could now build.
As a result, India did not share in the postwar growth miracle

- Between 1950 and 1974, India’s trade grew by less than 3% a year, while world trade was growing by more than 8%.
- India’s export/GDP ratio fell from 8% to 4% over this quarter century, a period when those of virtually all other countries were rising.
- Investment was disappointing: gross investment rates were below 15 per cent and falling from the late 1960s.
- Inward FDI was almost nil.
It should not be surprising, then, that India underperformed

- Per capita income growth from the 1950s through the 1980s was barely 1.5 per cent p.a., which hardly made a dent in poverty.
- In the period 1960-80, India’s per capita growth rate was lower than that of the industrial countries, East Asia, China, the Middle East, and even than Latin America.
  - [You will see what I mean by “even than” next week.]
- Of the major regions, only Africa did worse.
  - [As we will see next week.]
- This is when economists began referring, pessimistically, to the “Hindu rate of growth.”
Then came the reforms of the 1990s.

1. Dismantling import controls and lowering tariffs.
2. Unifying and devaluing the currency; moving then to a managed float.
4. Abolishing licensing requirements on investment
5. Lowering tax rates.
7. Reforming banking system (encouraging private banks, commercializing public banks, strengthening prudential supervision and regulation).
8. Reducing financial vulnerabilities (like the share of short term debt in total debt)
9. Developing financial markets (allowing firms to issue bonds, domestic securities, and ADRs).
Results

- Growth accelerated in the 1990s not to Chinese levels but at least relative to earlier Indian levels (from 2% per annum to 5-6% per annum, as noted earlier).
- There was a one-fifth decline in rates of both rural and urban poverty in the 1990s.
Next came the ICT revolution, the advent of cheap broadband due to the bubble, and large-scale outsourcing.

- A literate population, much of which spoke English, was a strong advantage in this context.
- So too was an education system that focused on developing high-quality engineering-related skills.
- A more investment-friend environment (ease of entry, low tax rates) facilitated efforts to capitalize on this advantage.
- And growth accelerated further, to 7-8 per cent in 2004-5 and 9+ per cent in 2006-7.
Or so goes the conventional account

- In reality, as you have learned from the readings, the story is a bit more complex.
- Actually, the acceleration of growth appears to have begun earlier, well before 1991.
The growth acceleration appears to begin in the 1980s, not the 1990s when reforms supposed commenced.

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<td>GDP growth</td>
<td>3.7</td>
<td>5.9</td>
<td>6.2</td>
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<tr>
<td>Per capita growth</td>
<td>1.5</td>
<td>3.8</td>
<td>4.5</td>
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Visual evidence that the break occurred around 1980
Maybe reform still mattered but just began earlier.

- Indira Ghandi returned to power in 1980.
  - She adopted a more sympathetic attitude toward business (attempting to strengthen confidence if initially not doing much more).
- Rajiv Ghandi then took power in 1984 with a big parliamentary majority (following his mother’s assassination).
  - He was a new politician with new advisors.
  - He saw Japan rather than the Soviet Union as the relevant development model.
  - He implemented a modest degree of industrial regulation, import opening, capital account liberalization, and tax system rationalization. This was not big-bang reform as in 1991, but it was a significant step.
Gradualism vs. Big Bang

- We can think of this as “gradualism” instead of “big-bang liberalization” or as “experimentalism at la China.”
- This approach was designed to convince the public and politicians of the advantages of further reform. It allowed them to learn gradually about those advantages.
- Thus, Indira Ghandi’s pro-business policies encouraged investment by incumbent firms, which strengthened their support for yet additional reform under her son.
- But because reform was partial, acceleration in growth was tentative. Still, it was there nonetheless.

- So maybe Gerard Roland’s argument for gradualism may apply to India more than to the transition economies for which he developed it. This would be because:
  - India lacked a period of “extraordinary politics” for pushing through radical reform.
  - In a democracy (India in contrast to China), you have to convince a broad-based coalition of the merits of reform.
But partial liberalization also had a downside.

- It created conditions conducive to financial instability.
- And, in fact, the 1991 crisis in India exhibited all the standard characteristics of a “second generation financial crisis.”
  - India had liberalized capital imports without first completing other reforms.
  - Banks and other were allowed to borrow recklessly, as they then did. The government itself resorted to capital inflows to finance its deficit.
  - This borrowing financed big current acct deficit (4% of GDP) and rendered the economy vulnerable to a “sudden stop.”
Soviet collapse was the spark, but poorly sequenced reforms were the kindling

- India’s trade with the Soviet Union collapsed and growth slowed as a result (to 1.5% in 1990-1), disappointing investors. This was an external cause of the 1991 crisis.

- But poorly sequenced reforms (liberalizing short-term capital flows without first strengthening the banking system and moving to a more flexible exchange rate) compounded the problem.
  - After flowing in for some years, hot money flowed out. Nonresident Indians withdrew their rupee bank deposits. Foreign investors fled. Since short term debt was >100% of foreign reserves, this raised the danger of a rollover crisis.
But crisis bred reform

- The currency was devalued, and the government (including Manmohan Singh, then finance minister and now prime minister) restored investor confidence by pushing through additional reform (as in subsequent cases like Korea that we studied earlier in this course).

- [Additional factors influencing the change of course may have included collapse of Soviet Union, India’s traditional patron, and growing evidence that China, following India’s other Asian neighbors, was thriving under a growing market orientation.]

- The crisis provided impetus for accelerating the pace of reform.
So why isn’t India closing the gap vis-a-vis China?

- One answer is that this is an unreasonably high standard. 8-9% growth, if maintained, is not so bad…
- Another answer is that removing earlier distortionary policies (and reversing their legacies) is easier said than done. To whit:
  - Even today, China’s trade in goods is 50% of GDP, but India’s is only 20%.
  - China’s average tariff in 2001 was down to 13%, while India’s was still 28%.
  - Inward FDI is 12% of capital formation in China, as opposed to 4% in India.
  - Large budget imbalances that helped precipitate 1991 crisis have not been cut (consolidated deficit is still running at 10% of GDP).
  - Gov has repeatedly ignored recommendations that it simplify the tax system.
  - Its spending on distorting and inefficient subsidies (mainly to low productivity ag) have been rising, not falling.
  - India does much better at providing highly advanced education for the elite than at providing basic education for the masses. Illiteracy rate circa 2000 was still 34% in India, versus 6% in China.
  - Legacy of earlier distorting policies is still evident in obstacles to doing business (reservations for small firms (barring large firms from certain industries, either partially or entirely), difficulty of separating redundant workers and hence costs of ramping up).
  - Law laws remain draconian, making it difficult for firms to adjustment employment.
And the regulatory burden remains heavy

- Consider the number of days required (China versus India) to:
  - Start a business (45 in China vs. 90 in India)
  - Enforce a contract (245 vs. 420)
  - Register a property (30 vs. 60)
  - Restructure an insolvent enterprise (25 vs. 125)

- So the “license Raj” lives on
  - Constituencies develop for distorting policies
  - Again, history casts a long shadow.
Can India rely on software and call centers?

- Software, call centers and high-tech generally are seen as a way for India to sustain growth and lift the masses out of poverty.

- But employment in IT employment requires a college education, and only 6% of Indians have this. Is this a solution to the mass poverty problem?
If high tech isn’t a solution, then what is?

- Moving the masses into better paid jobs requires moving them into manufacturing, as in China.
  - Education helps here as well, but you don’t need to have completed university in order to be a productive worker in an assembly factory.

- But, relative to China, the expansion of manufacturing output and employment in India continues to lag.
Then if high tech isn’t a solution, what is?

- China has done than India in expanding the manufacturing share of employment – and thereby dealing with mass poverty. It’s bottom panel shows that India has compensated for this in some part by expanding employment in services – but only part.
The problem is barriers to faster expansion of industry (these will be familiar at this point in the lecture)

- Reservations for small firms.
- Other forms of intrusive regulation
- Hiring/firing restrictions.
  - In principle, firms with >100 blue collar workers cannot terminate them under any circumstances.
- Large fiscal deficits absorb resources needed for investment.
- Inadequacies of infrastructure.
  - In absolute terms, China is spending 8 times as much on infrastructure.
- Underinvestment in education.
  - Illiteracy rate remains 35%, compared to just 6% in China, as noted earlier.
  - Only 50% of children complete all 5 years of primary school, compared to 98% in China.
Implications for the future

- Development policy needs to be built on two legs: industry and IT-enabled services.
  - Expanding IT means improving infrastructure and delivery of education (relaxing virtual ban on private universities).
  - Expanding industry requires lowering tax rates, streamlining regulation, improving infrastructure.
- But would this be enough? Could India expect growth “China style” to follow?
- Growth Chinese-style requires high savings and investment rates. India has the demographic preconditions for this. Does it also have the requisite policy environment? Will democratic politics be a stabilizing or destabilizing factor?
Iclicker question: which economy will grow faster in the next ten years?

- A. India
- B. China